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Shareholder Value — The Great Fake

"The general perception that the US economy is in relatively good shape reflects a kind of revolution in what Americans expect of their economy – a revolution of falling expectations. Americans once expected their economy to deliver steadily rising standards of living, with each generation markedly better off than its parents. Today, we seem content with an economy that gives us living standards that creep up slowly if at all – so long as most people who want jobs can get them and inflation does not erode our paychecks too quickly."

—<u>The Age of Diminished Expectations</u>, Paul Krugman
The MIT Press, Cambridge, Massachusetts

For a number of reasons, the US economy is presently the envy of the world. It is booming beyond belief with real GDP expanding at an annual rate around 4 percent and unemployment at a postwar low. For East Asia, on the other hand, these are desperate days. Japan's economy, after seven years of minimal growth, is sliding anew into outright recession with shrinking GDP. Far worse than expected, and still worsening, is the economic news from Southeast Asia. In terms of GDP numbers, Europe is enjoying a sizable cyclical recovery, but in terms of employment and income people hardly notice.

But what is it really that is propelling the US economy? Is it the miraculous, durable produce of the new, smart American Capitalism which keeps management under relentless pressure to make companies leaner and fitter by restructuring, cutting costs and jobs to achieve extra-ordinary productivity gains and profits in a fiercely competitive global market? Or is it the deceptive strength of a "bubble economy"?

In this issue we will show that there has been a drastic shift in American corporate strategy, away from new investment and towards mergers and acquisitions and accounting ploys that bolster profits in the short run – but not long-term wealth-producing (and hence long-term profit-producing) capacity. In short, Corporate America has not only been slashing costs, but the long-term prospects for the healthy growth of aggregate income and purchasing power as well. Furthermore, with increasing pressures on U.S. corporations' margins, the jig may soon be up on Wall Street's corporate profits shell game.

<u>FALSE MIRACLES</u>

Our troubles with this exuberance about the great merits of American Capitalism have always started with two observations: first, the productivity and profit miracle that Wall Street hails and celebrates lacks any statistical evidence; second, present US economic growth appears outstanding in comparison to limping Europe and crashing Asia but, from a long-term perspective, US economic performance in the 1990s has been the poorest in this century, except for the Great Depression.

What, really, is the crucial gauge of a truly dynamic and healthy economy? In short, its ability to deliver a broad and sizable rise in living standards at low inflation rates. No economy can flourish in the long run without a general rise in living standards, essentially provided by rising productivity and rising wages, considering that wage earners are the most important customer in every economy.

Between 1948-73, both the European and the US economy did render a continuous increase in per capita income resulting from high productivity gains. The same was true of the Japanese economy until the late 1980s,

when vastly excessive money and credit creation turned it into a bust-prone bubble economy. And it was equally true of the East Asian economies until they ravaged their economic and financial structures with rampant credit excesses.

Actually, Asia's economic transformation has been one of the most remarkable accomplishments in history. Hundreds of millions of Asians have enjoyed a steep rise in their living standards. No other economic system has delivered so much, to so many, in so short a span of time. The most important features of this development — quoting the chief economist of the International Monetary Fund — were sound macroeconomic fundamentals: high savings, a commitment to education, technologically advanced factories, a relatively egalitarian distribution of income, and an aggressive pursuit of exports. The cardinal mistake of theirs was to permit the finally destructive money and credit excesses, fueling huge malinvestments, for which reckless foreign lenders and investors were at least as responsible as reckless domestic borrowers.

LOW INFLATION *DESPITE* MR. GREENSPAN

Asian hubris is dead; American hubris has taken over. Or should we more correctly say Wall Street hubris?

By widespread perception, and as persistently trumpeted by Wall Street, the US economy has in the last few years entered a "New Era" of superior managerial efficiency which has succeeded in blending stronger economic growth with minimal inflation and maximum profits, assuring together a long-term surge in private wealth through higher stock prices.

This extraordinary new thrust towards ever greater efficiency is supposed to be powered by the Wall Street-imposed imperative that corporate management has but one single responsibility — maximizing shareholder value — in other words, boosting share prices — and to pursue this aim without any regard of national identity and social consequences. In this world, the only thing that counts is the well being of managers and shareholders. But — courtesy of Adam Smith — as these two groups strictly pursue their own interests, the whole community is supposed to benefit from the additional overall gain in efficiency.

Measured by the exploding wealth creation over the last years through soaring stock prices, the new American capitalism appears a smashing success. Wealth creation of such magnitude in such rapidity is unprecedented in history. In the first place, though, we have trouble in allocating this achievement specifically to American Capitalism because just the same frenzied boom in stock prices has quite indiscriminately taken place in markets around the globe, the rare exception being the Asian boom-bust countries.

What, then, are the particular accomplishments of the new American Capitalism? Isn't inflation surprisingly low? Again, we have to say: This, too, is nothing peculiar to the US economy but a global fact of life. For the same reason, by the way, we refuse to give credit for the low inflation rates to central banks in general and Mr. Greenspan in particular. There is zero constraint on money and credit flows around the world. All over, central banks are holding their money spigots wide open, accommodating money and credit flows vastly in excess of available savings and the needs of economic activity. Patently, the global decline in inflation rates has happened despite unprecedented monetary looseness — in other words, despite Mr. Greenspan and his colleagues.

THE DEATH OF NEW INVESTMENT

But what else has then been repelling global inflation if not the central banks? We see two main forces, one positive, one negative. The positive one is the common global constraint on deficit spending by governments. The negative one is a massive shift in the corporate use of money and credit away from productive investment and toward buying up existing plant and equipment — mergers, acquisitions, and stock buybacks.

Principally, there are three possible ways a corporation can raise its profits: (1) productivity-enhancing

investment; (2) wage and cost cutting; (3) accounting ploys, including financial leveraging. For ages, corporate managers endeavored to boost their companies' sales and profits by borrowing for investment in new plant and equipment. Doing so, they brought prosperity to the whole community, not only to themselves and their shareholders.

Corporate culture in the present climate of American Capitalism is focused, instead, on cost-cutting. The hallmark of this capitalism is that corporations limit their investments to current cash flow or current depreciation charges, while expanding through acquisitions and mergers. Capacity creation through new investment has completely been replaced by asset shuffling. Corporate borrowing, actually, is expanding in record volume, but its proceeds end up mostly in the stock markets, not in production and trade. With this massive redeployment of corporate funds away from income-generating gross national product and into the asset markets implicitly goes a corresponding shift in the inflation pattern away from goods price inflation to asset price inflation.

Given extremely loose money, investment volume deflation has translated into rampant investment value inflation. Wall Street, corporate management and shareholders are pocketing fabulous profits in the form of paper wealth, while the rest of the community is being impoverished. Earlier we said about the Asian capitalism that it has delivered so much to so many. As for American Capitalism, no other economic system has delivered so much to so few.

To us, the new American Capitalism with its narrow emphasis on increasing shareholder value has always been an utterly foolish and weird concept because the basic idea behind it is to get rich at the expense of others, mainly at the expense of savers and workers. In the same vein, this "capitalism" completely ignores the most important question of all, and that is how the desired rise in share prices does come about. Cost-cutting, the favorite and dominant device today, may enable individual firms to improve their profits relative to those of their competitors, but it is no solution for the economy and corporations in the aggregate. Applied across the whole corporate sector, this policy stance inexorably becomes self-defeating because its net effect is to reduce aggregate income and purchasing power at the same rate as it reduces costs. In economic textbooks they call this the "fallacy of composition" (see page 7). This is a vicious example of this phenomenon set in motion.

INVESTMENT HOLDS THE KEY

The prime mover of economic growth is one thing only: investment expenditures. It adds first to the demand for goods, and afterwards to the supply of goods. If there has ever been one single point in economics on which economists of all schools have at all times agreed, it is the recognition that — quoting Keynes — investment, i.e. the increased production of material wealth in the shape of capital goods, alone increases national wealth.

Looking for the great efficiency gains from the new American Capitalism, where are they? The simple truth is that the US economy has not at all been doing well in the 1990s if compared with the past, except only for the Great Depression. The present expansion that began in the early 1990s has remained the slowest in the postwar period. The good looks of the US economy have more to do with the bad looks of the European and the Asian economies — and of course with Wall Street propaganda.

For comparison: During the first half of the post-World War II period, from 1948-73, the US economic pie grew at an average annual rate of 3.9 percent, of which 1.6 percentage points accrued from employment and 2.3 percentage points from productivity growth. The standard of living of the average American worker rose continuously in step with annual productivity growth of 2-3 percent together with a trend toward greater income equality. The role of the financial system was to transform available savings into investment and to allocate those limited funds to competing users. What's more, the US economy was productive enough to run a

persistent surplus in its current account, making the United States the world's leading creditor. Yet, nobody spoke of a "new economic paradigm". Everything was taken as just normal and ordinary.

Now to the 1990s: Over the last eight years, between the end of 1989 to the end of 1997, annual US real economic growth has averaged just 2.3 percent. Of that, 1.3 percentage points have come from employment growth and 1 percentage point from productivity growth, comparing poorly with the 2.3 percent average annual productivity growth in the prior half of the postwar period. Thus, the crucial negative is continuous low productivity growth. What's more, no longer is the US economy able to generate sufficient exports to pay for imports.

American companies are estimated to have invested nearly $225 billion last year alone in computer purchases, and half the labor force is now said to use computers in its work. The computer age is everywhere but in the productivity statistics. What's more, with the virtual stagnation of average wages went a dramatic worsening of income and wealth distribution between rich and poor. For sure, American capitalism has done wonders for stock prices. But this stock price miracle has nothing to do with superior productivity and profit growth and everything to do with loose money and a wholesale flight from low-yielding cash. It is most important to realize this and to keep it in mind.

EARNINGS DEBACLE

Recent US earnings growth numbers were the worst since 1991. Then, however, it was at the tail end of recession. This time, rather ominously, it has unfolded despite a booming economy. Still, it failed to unnerve Wall Street, apparently because high-riding expectations of corporate earnings growth over the next few years have survived and remain just as bullish as before. A strong profit rebound in the second half of the year to the customary double-digit rate of the last few years is still a foregone conclusion in the stock market.

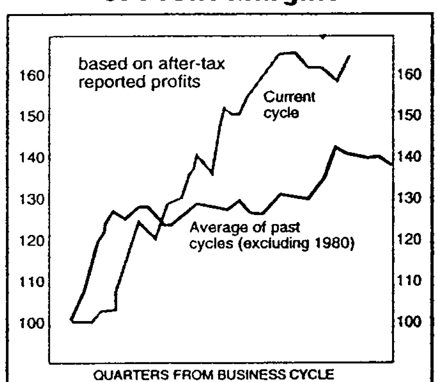
Actually, US profits started their steep increase in 1992, while the surge in stock prices began only in early 1995. Corporate profits before taxes gained over the five years 85 percent, or on average 17 percent per annum, as against an upswing in stock prices by 140 percent, or 28 percent annually.

Being the steepest ever rise in profits and profit margins in the whole postwar period, it became the key reason for explaining and justifying the following extraordinary bull run in stocks. For Wall Street, this profit explosion essentially reflected the successful cost-cutting and productivity-enhancement wonders of the new American capitalism, with its massive corporate restructuring.

There never was a shred of truth to this story. Officially recorded productivity growth over this five-year period, has totaled a shabby 4.5 percent, or 0.9 percent annually. The obvious, actual harbinger of the abrupt, uncommon profits gains was predominantly a drastic reduction in corporations' interest bill. Adjusted for this windfall gain, the US profit performance in the 1990s was in actual fact poorer than normal. Considering the sustained miserable productivity growth and the declining inflation rates, nothing else could be expected.

While stock markets and investors love the merger and acquisition frenzy, it is in reality symptomatic of an increasingly desperate struggle of corporations for higher profitability in the short run. The surging use by corporations of dubious ploys to bolster

Cycle-on-Cycle Comparison of Profit Margins



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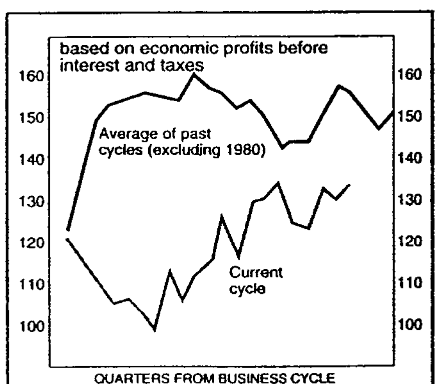


Source: Bank Credit Analyst

reported profits should be seen in this same light. Stock buybacks, lifting per-share earnings through the reduction of the number of outstanding shares, hit in the last two years $181 billion, up from $90 billion in 1995 and $70 billion in 1994.

Another rapidly spreading profit-boosting device is to substitute stock options for employee compensation in cash. Households now own an estimated $800 billion-worth of such options — ten times as much as in the late 1980s. As the cost of options is not charged to the corporations' income statements, this substitution is an easy way to puff up profits virtually by a change in bookkeeping. Last but not least, profits have also been considerably bolstered by the circumstance that the steep rise in share prices has relieved corporations of making contributions to their benefit plans.

These and other profit-enhancing influences and accounting ploys have proliferated as never before in the United States during the last few years. Taking them into account, we have long come to the conclusion that the prevailing obsessive emphasis on raising shareholder value (in other words, boosting stock prices), tends to provoke to this end far more corporate trickery than sound investment policies. This is because management benefits from higher share prices regardless of underlying causes.

No, share prices can't seriously be the test of an economic system. The really crucial test is current productivity growth and a rising living standard for the general public. American Capitalism has delivered neither. Making our judgment, we should be careful not to mistake bubble effects for signs of economic health.

Recently, the London Economist caused some public furor with various articles in which it postulated that the US economy has become a "bubble economy". While we basically agree with this verdict, our approach differs. A bubble economy exists when a given asset price inflation is transmitting important effects to the economy, distorting economic activity and resource allocation. Depending on circumstances, as we have explained before, the resulting bubble effects may be of very different kinds. In the case of Japan and the Pacific Rim countries, the most important distortions consisted in gross overinvestment in property and industrial capacity. In the U.S. the most important distortion is gross overconsumption.

REPLETE WITH BUBBLE EFFECTS

Where precisely are bubble effects in the US case? The following quotes from an article of the director of US economics of Goldman Sachs in the *Financial Times* give the answer:

"Why has the US economy performed so well in spite of so many restraints? One needs look no further than the booming US equity market. By boosting household net worth — adding about $1,000 billion in the first quarter and more than $6,000 billion since 1990 — it has encouraged households to keep spending. The strength of the stock market is the main reason why the personal saving rate fell to a 57-year low last year; why save out of income when the stock market boosted household net worth by 13 percent in 1997?

"As the equity market has continued to rise, the circle has become increasingly virtuous. For example, it has helped hold down compensation expenses...Pressures for higher wages have also been restrained as share options have become a more important component of compensation. Stock market strength has even helped push the federal budget into surplus. The rise in share prices has led to a surge in capital gains realizations, boosting tax receipts. Capital gains tax receipts should climb to nearly $100 billion this year, up from $44 billion in 1996. The importance of the stock market in keeping this virtuous circle intact cannot be overstated."

We couldn't agree more. Clearly, the stock market boom has become the US economy's engine of growth. The only difference we have with the author is that what he hails as the virtues of a "healthy stock market" are in our script the symptoms of a bubble economy literally riddled with unsustainable, major imbalances which will abruptly turn into a vicious downward circle once the stock market boom subsides. As a matter of fact, the

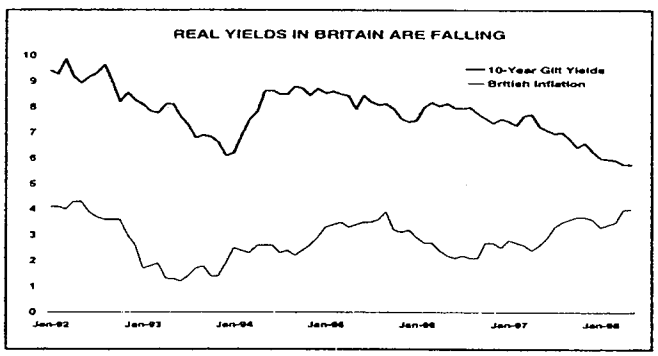
(continued on page 7)

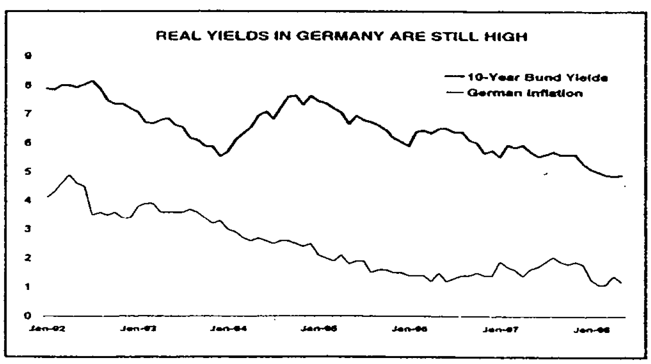
Don't Trust the U.S. Dollar or Euro-Euphoria? Then Buy Long-dated German Zeros

Optimism pervades continental Europe. Looking at the unequaled surge in Europe's bond and stock markets, investors are apparently betting that the euro party, to start next January 1, will prove a smashing success. We have repeatedly expressed our misgivings about economic developments in Europe, with or without a common currency. Though conventional wisdom holds that Europe's recovery will both broaden and accelerate, increasingly powered by strengthening domestic demand, we don't buy this logic. We see core Europe's export boom coming sharply off the boil, and bringing all of Europe's stock markets down when it happens. While stock investors will be punished, holders of longer-dated German zero-coupon bonds will be handsomely rewarded.

Though German bond yields appear low in nominal terms, looking at a chart of German 10-year-bond yields versus inflation, the real yield (defined as Nominal Yield minus Inflation) on German bonds is actually quite reasonable, and not much different from where it has been in recent history. And if we compare the lack of change in real yields in Germany versus the change in real yields in say, the U.K., it becomes clear that German bonds are more attractive. This is because for bondholders to make capital gains, interest rates must fall, and there is more room for a narrowing of the real yield in Germany than there is in the U.K.

But beyond the capital gains possible when the real yield shrinks in line with global levels, there are other factors that could cause the yield to come down and increase capital gains. Starting with the basics, a very loose "rule-of-thumb" technique for estimating the "fair value yield" on long-term government bonds is to add inflation expectations and GDP growth expectation together. In the U.K., inflation is running at 4.0 percent and GDP growth is at 2.8 percent, though long-term expectations are for less. Still, it is apparent that long-term bonds in the U.K. will not move quickly below their current yield of 5.8 percent. However, in Germany, inflation is running at 1.2 percent, with the economy growing at 2.5 percent. For the sake of argument, if we generously estimate long-run inflation at 1.8 percent and economic growth at 2.7 percent, it is entirely conceivable to see an equilibrium rate for German bond yields of 4.5 percent. Considering we're at 4.9 percent now, that conservatively estimated 0.4 point fall in bond yield would give holders of long-term German zeros a big payday.





If you've never bought zero coupon bonds before, you shouldn't be afraid of them. Zero coupon bonds (or "zeros") are the same as regular bonds with a guaranteed final payoff, except that they pay no interest. Instead, you buy them at a deep discount to their maturity value, and the bonds gradually rise to their maturity value over the years. At current interest rates (4.9 percent), a 10-year zero would cost about 62 cents on the dollar, maturing at the full dollar in ten years. If for example, interest rates fell to 4.5 percent over the next 12 months, that zero would move up to about 67.5 cents on the dollar, for a quick nine percent gain with minimal risk.

And risk is truly minimal. We're using the assumption that for our 62 cents today, we are guaranteed one dollar back in ten years, with the expectation that our 62 cents could possibly be worth up to 70 cents in a year if you don't use our safe-side estimates, for double-digit gains. Yet it is possible that our 62 cents would not appreciate at all — or even be worth less in a year's time — if interest rates unexpectedly spiked higher in the next twelve months. How possible is it? The chances are extremely remote. Long-term German interest rates would have to spike over 5.5 percent for you to show a loss in a year's time.

In this issue, we debunk American Capitalism as the great fake. Last month, we stressed the risks of euro-euphoria, but affirmed that the dollar will weaken versus the deutschemark during euro-fever over the next twelve months. So dollar-based investors holding German zeros will not only be able to reap significant capital gains on the bonds, but those gains will be compounded by the gains due to the weakening of the U.S. dollar versus the deutschemark/euro. This should comfortably push a dollar-based investor's return well into the double-digit range, again with minimal risk. —*S.S.*

* We recommend buying the German Government Zeros maturing in 1/08, series JA08, which currently trade around 62DM. If you need a good broker to place an order, contact our good friend and the President of Friedberg Mercantile Group, Neil Rackoff, at 1-800-474-2663, or 212-943-5300, fax 212-943-6890. Address: Friedberg Mercantile Group, 67 Wall Street,Suite 1901, New York, NY 10005.

(continued from page 5)

author indirectly admits this by warning that all these benefits would then instantly "evaporate...raising questions about the new economic era". To quote him further: "[The economy] could become sick quite quickly should the stock market sink and the virtuous circle end. The boom and bust in Japan is a good example of this."

To forestall a stock market and economic bust for America, he ponders that it may take a rise of more than 300 basis points in both short- and long-term interest rates. We think, he vastly underestimates the vulnerability of a bubble economy which the US economy definitely is, just as did Governor Mieno of the central bank of Japan, when he successively hiked rates with the declared intent to prick the speculative bubble before it burst, yet bigger, of its own accord. Mr. Greenspan, refusing the slightest rate hike apparently knows better of the vulnerability of the US economy.

What is the US economy without those bubble effects? An economy with very poor growth fundamentals: Among the industrial countries, it has the lowest savings and investment ratios; the lowest productivity growth, and a chronic, mammoth trade deficit associated with a rapidly rising mountain of foreign debts. What economic growth has occurred since 1980 has been achieved with an unprecedented compounding of debt. Faced with a persistent fall in real wages, the American consumer has attempted to maintain or raise his living standard by piling up incredible amounts of debt. Government debt has since then quintupled and consumer debt quadrupled. The consumers' debt ratio jumped from 60 percent to 81 percent of total income.

THE ROAD TO IMPOVERISHMENT

After all, we come to the absolutely crucial question: Are cost-cutting, mergers, acquisitions, restructuring and downsizing the road to prosperity, as propagated by Wall Street? In the following, we shall explain that they are not. It is a travesty of capitalism in self-destruction and in the longer run the road to general impoverishment. How anybody of some intelligence can believe otherwise is to us simply incomprehensible.

The prime movers of economic growth are profits and investments with the proviso that investment spending is normally the main source of profit for the business sector as a whole. To increase overall profits, total current corporate revenues have to rise faster than total current corporate expenses. The first point to see here is that mergers and acquisitions do not involve any income- and revenue-creation. Assets are exchanged, no more, no less, adding nothing to national wealth and overall business profits. Only expenditures on new plant, equipment and inventories do. To the extent that mergers and acquisitions occur at the expense of new investments, which they do, they diminish the overall growth of income, profits and national wealth.

Does wage and cost-cutting accelerate and improve economic growth? By itself, it definitely does not. Because wages and salaries are a major component of corporate costs, wage-cutting or wage restraint are supposed to boost profits. But there is a snag: If too many firms do the same, they reduce each others' revenues and profits, and total profits are bound to shrink. Instead, a cumulative downturn in economic growth and profits develops.

A similar paradox lies in the answer to the question, why firms should invest and add to their productive capacities if existing ones are underutilized. The answer is, these capacities are unprofitable and unemployed because new investment is lagging. Capitalistic economies are condemned to grow by investment or to perish.

PROFITS AND THE FALLACY OF COMPOSITION

Trying to assess the potential effects on profits, it is necessary to be on guard against the fallacy of composition, that is against influences or measures that may benefit a single company but which hurt corporations and economic growth in aggregate. This requires analyzing the flows of funds into and out of the business sector as a whole.

Let us start with a statement that we shall explain afterwards: The chief source of wealth and profit creation in every economy is rising investment in structures, equipment and inventories. Fixed investment is the creation of tangible wealth. At the same time, it is the chief profit source for business in aggregate because it increases business revenue without generating business expenses. All revenues increase business net worth, all expenses reduce net worth.

How is that? Patently, the firms that produce and sell the investment goods register a corresponding increase in their revenues. On the other hand, the firms that purchase the plant and equipment goods merely exchange one asset (cash, borrowed or owned) for a tangible capital asset. This acquision incurs no current expenses until the first depreciation charges are recorded. As a result, current business investment equals current business profits. Any increment to the production of investment goods, including inventories, becomes a corresponding increment to overall corporate profits.

In this way, the investment process for capital goods plays a key role in generating revenues and profits for the business sector in aggregate. Its essential flip side is that shrinking new investment in the wake of merger and acquisition mania is implicitly putting downward pressure on overall profits. In other words, the drastic shift in corporate strategy from new investment and towards mergers and acquisitions is no solution for the profit problem. Overall, it makes for lower profits. The key point really to see is the close connection between wealth creation and profit creation.

With reference to this profit equation, there used to be a famous saying among economists: Wage-earners spend what they earn, but capitalists (businesses) earn what they spend.

Wealth creation through capacity creation is for the corporate sector in this way the chief aggregate profit sources. However, business profits are further influenced by what happens in other sectors, of which there are three: private households, foreign (balance of payments), and government.

Private households generally spend less than they earn, causing a "savings gap" in the national income account which tends to squeeze aggregate business profits. But in the United States, personal saving has over the last years been ravaged by an unprecedented consumer spending binge, fueled by heavy borrowing and big wealth effects implicitly connoting massive dissaving. Measured by the Fed's flow of funds data, the personal savings rate has between 1994-97 suffered a steep plunge from 5.7 percent to 2.7 percent of disposable income. Lower savings inherently translate into higher business profits.

On the other hand, the US business sector is simultaneously exposed to a powerful revenue and profit killer: the rapidly widening current-account deficit hitting $214 billion in the first quarter of 1998, as against $117 billion in the quarter a year ago. The many people who belittle the importance of the trade deficit obviously don't realize its devastating influence on US profits through a combined labor-cost-pricing-power squeeze.

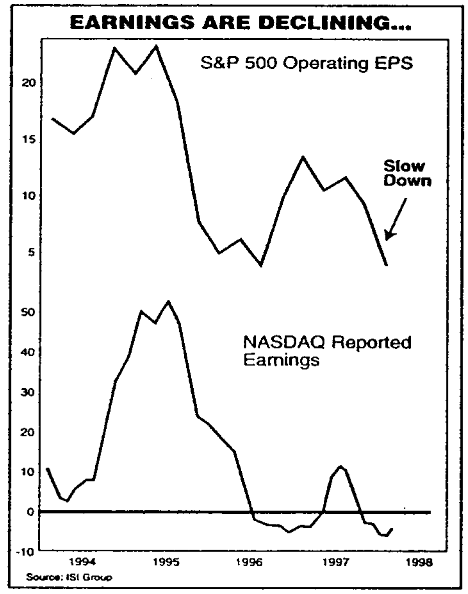
Such an import surplus implies that an equal amount of money and domestic incomes and purchasing power, coming largely from the wage bill of US businesses, is transferred to the foreign producers, who deliver the rising imports. US producers thus have the costs; foreign producers, the revenue. Not only that, the rising stream of goods from the big and rising import surplus onto the US market undercuts in addition the pricing power of US firms in their home market. As manufacturing imports now account for more than one third of total US spending

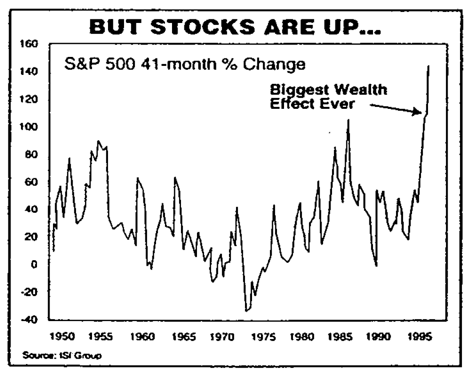
on manufacturing goods, this cost-pricing-power pressure makes together for a ferocious profit squeeze. We shall keep an eye on the development of the US trade deficit. Any further widening of the deficit signals worsening profits.

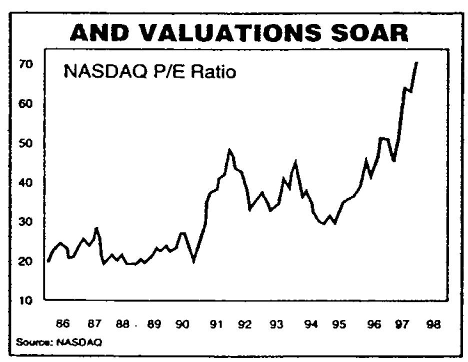
Over the last years, still another forceful profit killer is at work in the US economy: the dramatic shift in the Federal budget from a deficit of $250 billion in 1994 to a current small surplus. While this is rightly regarded as a basically sound development, we shouldn't overlook that it deprives the private sector, households and businesses, of a former huge credit-financed income injection which, intrinsically, tends to reduce business profits.

A PROFITLESS INVESTMENT BOOM

US profits actually peaked in the third quarter of 1997. Year-over-year, they have since then no longer kept pace with GDP growth, indicating shrinking profit margins. According to Merrill Lynch calculations, the US economy is in the worst profit margin squeeze in twenty years. S&P 500 profits per share are up only 2.5 percent y/y, while NASDAQ reported profits are down 4 percent y/y. But Wall Street looks away, forecasting and selling a steep rebound of profits later this year. Based on our flow-of-funds analysis, we can say with great certainty that the decline in profits will accelerate in the second half of this year. The only thing that could prevent or slow it is a new spurt in consumer spending in response to new, strong stock market gains at the expense of saving. On the other hand, a major decline in stock prices, depressing consumer spending and boosting savings, would presage a disastrous profit squeeze.







But isn't the US economy apart from the merger and acquisition mania also enjoying an unprecedented investment boom which, according to our flow-of-funds scheme, should tremendously boost corporate earnings? Last year, business fixed investment surged by 10 percent and in the first quarter of 1998 even at an annual rate of 17 percent. Over the last five years, capital spending has increased a cumulative 57 percent, the biggest investment boom since the 1960s. In 1997, fixed investment has contributed 1.6 per points — or 42 percent — to overall 3.8 percent real GDP growth, and in the first quarter of 1998 even 2.5 percentage points — or 52 percent — to overall 4.8 percent real annual GDP growth.

Well, from the perspective of profit generation, this was and still is a weird kind of investment boom. It's enormous in terms of increase in new computer power, but in terms of prices and profits, it is recession, as prices of high tech — the overwhelming component in the investment boom — collapsed 17.4 percent over the year. Besides, remember, reported profits specifically in the high tech sector are grossly overstated through the heavy use of stock options.

If exercised stock options were an employee cost, the

leading high tech firms in the United States (Dell, Intel, Texas Instruments, Cisco Systems, Hewlett-Packard, Microsoft) would have reported losses. But it is part of American Capitalism of the 1990s that the bull market is more important than correct financial reporting. Numerous leading firms — like Chase Manhattan, Coca-Cola, Walt Disney, Gilette and many others of similar stature — have grossly overstated profits. The 11 companies in the first table on this page would in 1996 have shown losses after adjusting their employment costs for exercised stock options, while the 12 companies in the second table would have seen their profits cut to one third or less.

Company	Reported Earnings ($mil)	Earnings Adjusted for stock option costs ($mil)
Dell Computer	498	-862
Intel	5,157	-281
Microsoft	2,825	-10,175
Cisco Systems	913	-656
Hewlett Packard	586	-30
Texas Instruments	63	-68
Monsanto	385	-597
Time Warner	191	-312
Unocal	36	-52
Bristol Myers Squibb	2,850	-2,582
Eli Lilly	1,524	-1,648

Source: Smithers & Co., London

It may be argued against this kind of calculation that the corporations would and could never have accorded these opulent employee compensations if they would have had to be made at the expense of cash flow and corporate earnings. Nevertheless, they highlight that there are tremendous distortions in the financial picture of Corporate America and that management is increasingly resorting to dubious ploys to bolster reported profits in order to meet the high-riding expectations implanted into the markets. What started as an incentive to management has degenerated into an outright instrument for profit manipulation, as a rapidly growing number of firms is granting stock options to a broad range of employees.

Company	Reported Earnings ($mil)	Adjusted for option costs ($mil)	% of over-statement
Chase Manhattan	2,461	631	390%
Coca-Cola	3,492	1,686	207%
Computer Ass. Int.	261	47	550%
Gilette	949	127	749%
MBNA	474	211	225%
Merryll Lynch	1,619	353	459%
Oracle	603	157	384%
Schlumberhger	851	249	342%
Sun Microsystem	620	205	302%
Textron	253	74	340%
Walt Disney	1,534	689	223%
Warner Lambert	787	228	345%

Source: Smithers & Co., London

MORE PROFIT CHEATING

The simple truth is that with 4-5 percent maximum nominal GDP growth, persistent 10-15 percent corporate profit growth is just impossible. A myth has been created that mergers, acquisitions and restructuring are able to deliver such profits in infinity by some efficiency miracles. This is worse than complete nonsense because, as explained, the precise opposite is true. This American Capitalism with its frenzied wheeling and dealing between firms and its chronic consumer borrowing and spending binges is the road to falling living standards. Not capital formation but capital consumption is its hallmark.

Earlier we said that the "shareholder value" system is prone to invite more short-run profit cheating than to assure sound long-term policies. True-to-type, in this respect, is the way corporate management and Wall Street are trying to deceive investors about the developing profit deterioration by the trickery of anticipatory cuts in "expected profits". The following two tables illustrate this game to deceive and manipulate public opinion.

What happened is this: Last December, the consensus predicted for the first quarter a rise in profits y/y of 10.7 percent. Guided by management, these forecasts had by Feb 27 dwindled to 4.3 percent and by Apr 10 just before the reporting season started, further to 0.5 percent. Actually, earnings are up 3.5 percent y/y, which represents a sharp slowdown. But measured against the last, drastically lowered earnings estimates, this gives the appearance of an improvement which, on the face of it, justifies the bullish Wall Street message that profits are again generally "better than expected". The first table on the next page reveals this part of the systematic deception.

Everybody speaks of the indefatigable strength of the US economy and the accelerating economic recovery in Europe. In our view, there is on both continents more deceptive than real economic strength. The US economy's growth has in the recent years been decisively driven by the big wealth effects from the stock market boom, and the European economy, in turn, has been decisively driven by the resulting inflated US domestic demand.

US PROFITS UNDER CONCENTRIC ATTACK

As already mentioned, we expect further substantial profit deterioration in the United States. Consider that profits were in the first quarter down again 2 percent, even though the economy accelerated to a record annual rate of 4.8 percent. What is going to happen to profits, when the economy slows down? Given our analysis that the US economy's growth pattern is extremely unbalanced, we expect a sudden, dramatic slowdown sooner or later. There is an outright profits disaster waiting to happen. We draw this conclusion from our flows-of-funds analysis, as explained.

First Call Survey of Analysts' Estimates 98: Q1 S&P 500 Operating EPS Y/Y%

DECEMBER 19	FEBRUARY 27	APRIL 10	END-MAY
10.7%	4.3%	0.5%	3.5%

From a macroeconomic perspective, the two most obvious and also most important factors behind the US profit squeeze were the rising labor costs on the one hand, and the jump in the trade deficit slashing business revenue and pricing power on the other. There is reason to expect worse to come from Asia. However, additional major threats to profits — from domestic sources — are unfolding. No less than a concentric attack on US profits is under way.

Capital spending, after declining q/q in the fourth quarter of 1997, has rebounded in the first quarter. But given the unfolding profit squeeze, it is likely to slow in the upcoming quarters. Virtually inevitable is a sharp slowdown in inventory buildup, which has heavily contributed to recent GDP growth. A further unmistakable, major contractive onslaught on US domestic incomes and thereby also on business profits is imparted by the rising budget surplus.

S&P 500 Operating Earnings Per Share Y/Y %

97:1Q	97:2Q	97:3Q	97:4Q	98:1Q	98:2Q	98:3Q	98:4Q
13.8%	10.4%	11.8%	8.9%	2.5%	7.0%E	12.0%E	17.0%E

E = First Call survey of analysts' estimates
Source: ISI International Strategy & Investment

The single, biggest unknown in the macroeconomic profit equation is for the time being personal savings. Its virtual collapse in the last three years to a historic low, propelled by the huge wealth effects delivered by the booming stock market, has played a key role in boosting economic growth and business revenues, and therefore profits. We find it hard to conceive of a further stock-market-driven, profit-boosting consumer spending binge. In its absence, higher savings would add to the profit squeeze. A prolonged, sharp decline in stock prices would have devastating effects on the whole economy. Asset price inflation has become the indispensable, new drug for the US economy. If it stops, economic growth stops.

MASSIVE RESOURCE MISALLOCATIONS

On closer look, the US economy's widely admired growth momentum had in the last two, three years two main engines: The one was massive income-creation by means of frenzied consumer borrowing and dissaving, both heavily related to the stock market boom; and the other one was the frenzied computer boom accounting for 30-50 percent of real GDP growth. Manifestly, this is an extremely unbalanced and unsustainable growth pattern.

Inflated growth of domestic demand and spending essentially distorts the whole warp and woof of the economy concerned (Austrian theory). The most striking imbalance of the US economy is its chronic, mammoth export-import gap. Its internal counterparts are undersaving and, as its flip side, overspending on consumption. In short, the US economy's investment structure is extremely lopsided. Obvious gross overinvestment in high

tech and consumer-related structures, except manufacturing capacity, contrasts with persistent underinvestment in general manufacturing, resulting in the perennial failure to produce a sufficient volume of manufactured exports to pay for imports at the economy's present growth rates.

For us, frankly speaking, the Wall Street fantasies about the miraculous efficiency effects of shareholder value as the prime measure for corporate performance have always been complete nonsense. With the public becoming monomaniacal for markets and managers, this concept has elevated "short-termism" in thinking and in corporate policies to new heights. Looking at capital formation and productivity growth, the essence of healthy capitalism, the so-called American Capitalism is a great fake. It is a decadent kind of capitalism that inexorably undermines long-term economic growth. It's a system, in which financial gimmickry and manic asset trading has largely displaced capital formation in tangible assets. The inherent result is that a few are immensely enriched through commissions and exploding paper wealth. But the decisive thing to see is that capital formation alone, through its broad and cumulative income — and productivity creating effects, is able to generate prosperity for all in the long run. We should not be astonished that our standard of living has in general stopped rising.

CONCLUSIONS:

It is now clear that the dismal profit performance is the main threat to the global stock market boom. The bulls' justification for soaring valuation in the market has been persistent strong earnings growth, and now it has vanished altogether. And worse is to come. In Europe, profits are still up. Nevertheless, European stocks are sure to follow US stocks down.

There is conclusive evidence that the Pac Rim countries are collapsing into recession. Capital outflows are hitting major economies in South America and Eastern Europe, heavily impacting currencies, stock markets and interest rates. Including Japan, more than one third of the world is now in recession or depression.

But the stock markets in Europe and America have eyes only for the low inflation rates and the loose and cheap Japanese money, supposedly promising further floods of money for the markets.

Though the US economy still has strong momentum, it is, for the reasons explained, highly vulnerable. Later this year, it will abruptly and sharply slow down. Contrary to bullish Wall Street forecasts, profits will not rebound but accelerate their decline, finally devastating the bullish profit arguments.

As to currencies, we stick to our forecast that we have been making for months: Brace for a prolonged fall of the dollar against the European currencies. Given the dramatic decline of profits on the horizon, the end of the bull market has arrived — or is at the very least in sight.

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